for the present year combined with the retained net profits of the preceding 2 years. This statute is made applicable to State member banks by the sixth paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 324).

(b) The purpose of this provision is to prevent the depletion of the capital structure of a bank by the payment of excessive dividends. Since a stock dividend does not result in the distribution of cash or assets, the Board does not consider the term *dividend* in this statute as including stock dividends. Consequently, the Board's approval for the declaration of a stock dividend is not required.

(12 U.S.C. 60)

[33 FR 9866, July 10, 1968. Redesignated at 55 FR 52987, Dec. 26, 1990]

§ 208.126 Payment of dividends; effect of net losses.

(a) Section 5199(b) of the Revised Statutes (12 U.S.C. 60), as amended in 1959: *Provides,* That:

> The approval of the Comptroller of the Currency shall be required if the total of all dividends declared by [a national bank] in any calendar year shall exceed the total of its net profits of that year combined with its retained net profits of the preceding 2 years * * *

Under the sixth paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 324), member State banks are required ''to conform to the provisions of section 5199(b) * * * with respect to the payment of dividends'', except that the approval of the Board of Governors is required in lieu of the approval of the Comptroller.

(b) The question has arisen whether it is necessary in determining whether a bank's dividends in a particular year ''exceed the total of its net profits of that year combined with its retained net profits of the preceding two years'', to take into consideration the amount of a net loss in the current year or in one or both of the preceding 2 years.

(c) The purpose of the 1959 amendment of section 5199(b) was to prevent a bank from paying a dividend (except with supervisory approval) unless it has on hand, from operations during the 3 latest years, sufficient net profits to cover the proposed dividend. If a net loss for one or more of those 3 years was disregarded in making the calculation called for by section 5199(b), a member State bank could pay dividends, without the approval of the Board of Governors, even though the aggregate results of the 3 latest years' operations was a net deficit. This was precisely the sort of situation in which Congress intended to prevent the payment of a dividend unless the supervisory authority was satisfied that special circumstances justified the proposed dividend.

(d) Accordingly, it is the position of the Board that, in making the calculation required by section 5199(b), it is necessary to take into consideration the actual results of operations during the current year and the 2 preceding years, whether the figures for those years are plus or minus figures. For example, if a bank had

(1) Retained net profits of $30,000 from 1959;

(2) A net loss of $40,000 in 1960 (and dividends of $10,000 were paid in that year, with the Board's approval); and

(3) Net profits of $20,000 in 1961,

It could not pay any dividend in 1961 without the Board's approval, since the calculation required by section 5199(b) would result in a zero figure ($30,000 minus $50,000 plus $20,000). It will be noted that, for the purposes of section 5199, any dividends paid in a loss year must be included in the ''net loss'' for that year, just as dividends paid in a profitable year must be deducted from ''net profits'' in calculating ''retained net profits''.

(12 U.S.C. 60)

[33 FR 9866, July 10, 1968. Redesignated at 55 FR 52987, Dec. 26, 1990]

§ 208.127 Payment of dividends exceeding net profits to date of declaration.

(a) Section 5199(b) of the Revised Statutes of the United States (12 U.S.C. 60) and the sixth paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 324), provide in effect that ''the approval of the Comptroller of the Currency (or the Board of Governors) shall be required if the total of all dividends declared by such association (a national bank or a member State bank) in any calendar year shall exceed the total of its net profits of that year combined with its retained net profits of the preceding two years.''

(b) The question has been presented whether the Board's approval must be obtained when the amount of a dividend proposed to be declared by a member State bank, prior to the end of the calendar year, would exceed the total of the bank's net profits up to the date of the declaration, combined with its retained net profits of the preceding 2 years.

(c) If the question related only to the literal meaning of words, divorced from the statute's underlying purpose and from the factual situations to which it relates, it might be contended that since the statute refers to ''all dividends declared * * * in any calendar year'' and ''the total of its net profits of that year'', its applicability cannot be determined until the calendar year is completed. As explained below, however, such an interpretation is not required by the language of the statute and would substantially defeat its purpose, as revealed by the legislative history; and consequently it is believed that the statute should be construed as relating to dividends declared, and to net profits, in the calendar year up to the date of such declaration.

(d) The purpose of the statute was described as follows by the Senate Banking Committee:

> This provision is designed to restrict the payment of dividends * * * where such payments would result in dissipating needed capital funds. This provision strengthens the regulatory authority of the Comptroller [and the Board of Governors]. Under it, he will be able to prevent the declaration of dividends which are not justified by current and recent accumulated earnings, and which would result in a weakened and undercapitalized bank and violate safe and sound banking practice.

(S. Rep. No. 730, 86th Cong. (Aug. 19, 1959), pp. 6–7)

(1) It seems that Congress had in mind the following test: At the time the dividend is declared, does the bank have available, from profits of the current calendar year and the 2 preceding calendar years, enough profits to cover the dividend? If not, the dividend may not be declared and paid unless the Comptroller or the Board of Governors specifically approves, in view of the circumstances of the particular case.

(2) Bearing in mind the Senate Committee's reference to ''dissipating needed capital funds,'' it is obvious that the danger that a proposed dividend would unduly weaken a bank's capital structure is just as great if the dividend is declared in June as if it is declared in December. If a bank does not have profits on hand sufficient to cover a proposed dividend, the fact that the declaration is made in 1 month rather than in another has little or no bearing on the extent to which payment of the dividend may unduly diminish the capital ''cushion'' on which depend the bank's continued existence and the safety of its depositors.

(e) An illustration may be helpful. For simplicity, let us assume that a member State bank opened for business on January 1, 1959, with a capital structure of $300,000, as required by the supervisory authorities. The bank had no net profit in 1959 or 1960. Up to June 30, 1961, it still has no net profits, but nevertheless the directors declare a dividend of $20,000 on that date. The bank's capital structure is thereby reduced from $300,000 to $280,000. It seems that this was precisely what Congress intended should not happen unless the Board of Governors approved the dividend, for adequate reasons. An undesirable situation would exist, and the Congressional purpose would be defeated, if such a weakening of the bank's capital structure were permissible if the dividend was declared and paid (without supervisory approval) in June, whereas the same action would involve a violation of the statute if the dividend was declared and paid, instead, in December. This might actually mean that no violation of section 5199(b) could occur except with respect to end-of-year dividends—unless, perhaps, it could be established that the bank's directors, when they declared the dividend earlier in the year, knew (or had reason to believe) that the bank's net profits for the entire year would not be sufficient.

(f) The statutory reference to ''all dividends declared * * * in any calendar year'' can be interpreted, even from the viewpoint of literal meaning, as referring to dividends declared in a calendar year up to the date of declaration. Particularly because the clear Congressional purpose would otherwise be largely defeated, it is concluded that this is the correct interpretation and that, consequently, the declaration by the member State bank, without the Board's approval, of a dividend in the amount of $20,000 would be in violation of the applicable statutes, since the amount of that dividend would exceed "the total of (the bank's) net profits of that year combined with its retained net profits of the preceding two years."

(12 U.S.C. 60)

[33 FR 9866, July 10, 1968. Redesignated at 55 FR 52987, Dec. 26, 1990]

§ 208.128 Commodity- or equity-linked transactions.

(a) State-chartered banks that are members of the Federal Reserve System are required to obtain the approval of the Board under Regulation H (Membership of State Banking Institutions in the Federal Reserve System) before permitting any change to be made in the general character of their business or in the scope of the corporate powers they exercised at the time of admission to membership. The Board has considered whether engaging in transactions linked to commodity or equity security prices or indices would represent a change in the general character of the business of a state member bank.

(b) Banking organizations have developed a number of commodity- or equity-linked transactions in which a portion of the return is linked to the price of a particular commodity or equity security or to an index of such prices. These transactions have been offered in a variety of forms, including commodity-indexed deposits, loans, debt issues, and derivative products, such as forwards, options, and swaps. In these transactions, the interest, principal, or both, or payment streams in the case of swaps, are linked to the price of a commodity. In addition, banks are also entering into exchange-traded commodity or stock-index futures and options in order to hedge the exposure inherent in these transactions. These types of transactions have been linked to a variety of commodities, including gold, oil, aluminum, and copper, as well as individual securities and stock indices.

(c) With the exception of gold, silver, and, in some cases, platinum, banks are not empowered to purchase or hold the commodities or equity securities that underlie these transactions. Although commodity-linked transactions settle only in cash, they effectively expose banks to commodity or equity market price risks. Thus, linking payments to commodities or equities may present risks with which banks generally are not familiar, and the inability of the bank to purchase the commodity or equity security to which a transaction is linked may increase the difficulty of hedging the exposure created by such transactions.

(d) The Board has determined that engaging in transactions linked to commodities or securities that a state member bank does not have the authority to purchase and hold directly should generally be considered a change in the character of the bank's business unless the transactions are entered into on a perfectly matched basis.[1] State member banks that wish to engage in commodity- or equity-linked transactions that are considered to be a change in the general character of their business should obtain Board approval before initiating these transactions or, in the case of activities commenced prior to the adoption of this interpretation, to continue such activities. Applications to continue such activities should be submitted on or before February 3, 1992.

(e) Transactions linked to securities or monetary metals that a state member bank is authorized to purchase and

[1] The term *perfectly matched*, as used in this interpretation refers to transactions that are entered into on a matched basis, that is, offsetting transactions where the counterparties for both transactions have been found before the bank enters into either transaction and the transactions are consummated on the same day. Offsetting transactions include transactions that have a price differential to provide the bank with its usual and customary fee or commission for its services. The exemption from prior approval for perfectly matched transactions would include mirror image equity swaps executed by a state member bank with any affiliate that is authorized under Regulation K to engage in equity swaps.